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IN THE

Supreme Court of the United States

October Term 1963

No. 940

BURLINGTON-ROCK ISLAND RAILROAD COMPANY, a corporation, *Petitioner*

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI
To The United States Court of Appeals For the Fifth Circuit

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PETITION FOR A WRIT OF CERTIORARI To The United States Court of Appeals For the Fifth Circuit

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Petitioner prays that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled case on August 27, 1963.

Citations to Opinions Below

The opinion of the District Court (R. 32-41), is reported in 220 F. Supp. 681. The opinion of the Court of Appeals, printed in the Appendix hereto, *infra*, p. 15, is reported in 321 F.2d 817.

Jurisdiction

The judgment of the Court of Appeals was entered on August 27, 1963. R. 63; p. 27 *infra*. Rehearing was denied on December 27, 1963. R. 107; p. 28 *infra*. The jurisdiction of this court is invoked under 28 U.S.C. 1254 (1).

Questions Presented

As a matter of procedure:

I. In a suit by taxpayer in the United States District Court for refund of federal taxes, involving the enforceability in the tax year of an obligation as between taxpayer and a third party, is the Government properly entitled

A. To raise in avoidance of the admitted obligation the possibility of an affirmative defense; such as limitations or as here an executory accord, which is available under local law to the obligor above,

B. To receive unqualified acceptance of that defense, despite the absence of facts proving the various elements thereof, including its availability to the obligor, but in the presence of other facts disclosing conduct by the holder inconsistent with an intention to rely thereon, and

C. To reap the benefits not only of having that defense at issue but also of having the burden with respect thereto on taxpayer, when the defense was neither pleaded by the Government nor fairly raised by the stipulation of facts on which the case was submitted?

AND

II. On review by the Court of Appeals, where for the first time the affirmative defense of an executory accord is raised, is it error for that Court

A. Even where the case has been submitted below on a stipulation, to make *de novo* findings in support of the new theory, and,

B. In accordance with the doctrine of affirmance where the decision of the trial court is supportable on any sound theory, to affirm on a theory as to which the relevant facts were never adequately developed?

On the merits:

III. Will an obligation to pay thirty days after notice, or earlier upon the occurrence of a specified contingency, although providing sufficient certainty of time of unconditional liability as to support negotiability, also provide sufficient like certainty to support an accrual for tax purposes?

Statutes Involved

"There shall be allowed as a deduction all *interest* paid or accrued within the taxable year on *indebtedness*." (Emphasis supplied.) Internal Revenue Code of 1954, § 163.

Statement

This litigation commenced with taxpayer's assertion in the District Court below of a right to a deduction in the year 1954 for *interest* accruing on judgments earlier obtained against it, by coincidence in the same court, and has now culminated in a Court of Appeals holding that

those same judgments did not constitute an *indebtedness*. The petition for a writ is concerned primarily with the circumstances by which taxpayer's *indebtedness* was considered to have been put in issue, and the still puzzling failure of the federal judicial system to afford taxpayer an opportunity to be heard on facts indispensable to the theory summarily held responsible for eliminating that *indebtedness*. Taxpayer here seeks assurance of the right to that opportunity.

The facts, material to this petition and lifted verbatim from the pleadings and stipulation when relevant to the question of burden of proof or matters at issue, are as follows:

Taxpayer's stock and first mortgage bonds issued at the turn of the century to finance construction of its line, along with certain receiver certificates subsequently issued, were equally acquired and thereafter continuously held by The Colorado and Southern Railway Company and Chicago, Rock Island and Pacific Railroad Company. (R. 14.)

Taxpayer defaulted on the bonds and certificates, and in 1946, the two creditors obtained judgments against taxpayer in equal amounts aggregating $19,659,844.66. "Under the laws of Texas (Article 5072 of the Revised Civil Statutes of Texas) and pursuant to the order of the said Court, interest thereafter accrued on the entire amount of said judgments at the rate of 6% per annum." (Complaint and Answer, R. 5-6, 8.)

In 1950, taxpayer with Interstate Commerce Commission approval ceased to be an operating railroad and leased its lines to The Fort Worth and Denver Railway Company

and the Chicago, Rock Island and Pacific Railroad Company at an annual net rental of $375,000.00. (Stipulation, R. 15; Lease in full, R. 19-28.)

At approximately the same time, and "Under date of June 1, 1950, Plaintiff [taxpayer] entered into an agreement with its two said creditors providing for priority and allocation of payments on the said judgments obtained in 1946." (Complaint and Answer, and Stipulation; R. 6, 10, 16.)

Said agreement, after reciting the existence of and current balance due on said judgments, provided as between the parties that taxpayer "agrees from time to time, insofar as its cash position will reasonably permit, to make payments on account of said judgments in equal amounts to the Rock Island and the Colorado and Southern, such payments to be applied, and Burlington-Rock Island, Rock Island, and Colorado and Southern agree to apply same, on account and in reduction of that part of the said judgment representing the obligation arising on the principal amount of the Receiver Certificates, so long as any portion thereof remains unpaid." (Stipulation, Ex. C.; R. 29-31.)

Further payments were to be applied, and the creditors "agree to apply same, on account and in reduction of" the remaining 'parts' of the judgments, and thereafter "payments shall be in reduction of interest payable on said judgment," but "no amount shall be paid or be deemed to have been paid" on interest until principal has been paid. (*id.*)

The Agreement was terminable on thirty day's notice by any party thereto. (*id.*)

Between the date of said agreement of June 1, 1950, and December 31, 1954, taxpayer paid its two said creditors $1,153,761.87, "and as of December 31, 1954, it was indebted in the aggregate to its two creditors in the amount of $18,503,582.79 on the remaining amount of said judgments of July 9, 1946, not including interest on said judgments."

"Except as they might be affected by the aforesaid agreement of June 1, 1950, said judgments were outstanding as a continuing liability of plaintiff throughout the year 1954, and, under the laws of Texas [Citation] and pursuant to the order of the said Court, interest accrued on the unpaid balance at the rate of 6% per annum." (Stipulation, R. 16.)

Taxpayer also alleged:

"(6) In 1954 Plaintiff was indebted to The Colorado and Southern Railway Company and Chicago, Rock Island and Pacific Railroad Company, on which indebtedness Plaintiff's liability accrued at the rate of 6% per annum."

The Government answered:

"(6) Admits the allegations of paragraph (6) of the complaint, except denies that plaintiff was entitled to accrue interest liability at the rate of 6% per annum." (R. 5, 9.)

Taxpayer, keeping its books and reporting its income on the basis of the calendar year and accrual method, accrued on its books and deducted on its return the interest on the judgments. Upon disallowance of the interest deduction and payment of the resulting deficiency, suit was brought on a claim for refund pursuant to 28 U.S.C. §1346(a)(1). (R. 13, 16-17.)

The Government's answer, except for formal admissions and those noted above, was comprised of disclaimers of knowledge or simple denials of error in disallowing the interest deduction. (R. 9-11.)

The District Court, observing in its opinion that but for "the Allocation Agreement, the interest would, in all likelihood, be accruable as it arose from year to year," denied the refund (1) on the ground of uncertainty of payment since, based on taxpayer's current level of income, complete retirement of the judgment obligations was found to be a matter for the distant future, and (2) on the ground that taxpayer's obligation for interest was contingent, because payments of the interest on, as well as the principal of, the basic judgment obligations were to be made only from available cash, and because subordination of the interest to principal rendered the interest obligation conditional. (R. 37-41.)

In the Court of Appeals taxpayer observed that its obligations had hardly been rendered less onerous by the Allocation Agreement, since thereafter the creditors could without violating any of its terms still have levied execution on the judgments. This observation drew from the Government, for the first time, the assertion of a theory of affirmative defense which, if valid, would have enabled taxpayer to enjoin enforcement of the judgment obliga-

[illegible] is undisputed that the Allocation Agreement represented financial salvation for taxpayer, since by providing for application of payments first to principal, it permitted taxpayer to avoid the running of interest on principal thus retired, enabling not only taxpayer to pay both interest and principal out of projected income alone but also the court to so find. Nor is it disputed that precisely the same result could have been achieved by a simple direction accompanying each payment to credit it to principal

tions. Thus was spawned in Appellee's brief on appeal the theory of an executory accord. Taxpayer replied that one of the elements critical to the formation of an executory accord, an accord which here would lead to the rather shocking substitution of judgment obligations for a vacant promise to perform when able, is a clear offer and an unmistakable acceptance of the new performance in lieu of the old, and that there was simply nothing by way of manifestation of intention to which the Government could point as justifying, much less requiring, any agreement on the part of the creditors to substitute the "new" performance. The Government did not further press or even mention the theory in oral argument. (Brief of Appellee, 16-18, Reply Brief of Appellant, 11-12.)

The Court of Appeals, construing the Allocation Agreement "basically, to be an executory accord," supplied the necessary requisite of an intent to substitute with its own finding:

> "Here, Burlington's two stockholder-creditors agreed to accept in satisfaction of their judgment the taxpayer's performance of the conditional promise contained in the Allocation Agreement." Appendix, p. 23. (R. 58)

On motion for rehearing, taxpayer suggested that the Court had committed fundamental error when on "review" *de novo* findings had been made as to ultimate facts or at least as to mixed questions of fact and law, even where the case is tried below on a stipulation, without the benefit of the prior findings of the body charged with the primary responsibility of acting as the trier of fact, citing as con-

trary in principle to that result a decision of this Court." (R. 104.)

The request made of the Court to remand[3] for the purpose of affording an opportunity for development of

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[2] **S.E.C. v. Chenery Corp.**, 318 U.S. 80, 63 S.Ct. 454 (1943); See **Boehm v. Comm.**, 326 U.S. 287, 66 S.Ct. 120, 121 (1945); **Lundgrew v. Freeman**, 307 F.2d 104, 113-115 (9th Cir. 1962); **Lamb v. I.C.C.**, 250 F.2d 328, 360 (10th Cir. 1918); **Commercial Standard Ins. Co. v. Universal Underwriters**, 282 F.2d 24 (10th Cir. 1960).

Other reasons were assigned to support error in accepting the Government's belated theory, among them:

(1) The holding enables the Government, a third party, to raise an affirmative defense available, under local law to the taxpayer, alone a result on principle in conflict with the decisions of the Seventh Circuit (**Arthur R. Jones Syndicate v. Comm.**, 23 F.2d 853 (1928) (usury)) and of the Sixth Circuit (**First National Company v. Comm.**, 280 F.2d 861 (1961) (breach of fiduciary duty).

(2) In reaching the conclusion that the rights of the judgment creditors could not have been enforced, the court first holds the Allocation Agreement to be an executory accord, a holding facilitated by its own prior finding. It next assumes the success of a defense based thereon in any action asserting judgment rights, an assumption which presupposes availability predicated on a showing of compliance with the new agreement urged in avoidance. That compliance is not disclosed by the record and it can not be supplied by an implied or presumed finding (5 C.J.S. 1312). Compliance may be supposed only if the burden of proof as to nonavailability of the defense was on taxpayer, a supposition clearly impermissible under the decisions of the Sixth Circuit (**Routzahn v. Brown**, 95 F.2d 766 (1938)) and the Seventh Circuit (**U.S. v. First Wisconsin Trust Co.**, 92 F.2d 840 (1937)). The Court further assumes that the defense would necessarily be relied on by its holder, an assumption as to which the conduct of the holder in continuing to recognize the judgment obligations is clearly contrary. That mere availability of an affirmative defense should in and of itself be sufficient to bar the obligation is a result contrary in principle to the decision of the Ninth Circuit (**Smyth v. Barneson**, 181 F.2d 143 (1950), limitations) (R. 91-95).

[3] **Crabb v. Comm.**, 121 F.2d 1015 (5th Cir. 1941) on motion for rehearing.

the facts relevant to the affirmative defense of an executory accord[1] was denied. (R. 105-107.)

REASONS FOR GRANTING THE WRIT

1. The decision below can not be supported on the alternative grounds either that the interest obligation was uncertain of payment or that it had been rendered conditional because of the instant subordination. Neither certainty nor uncertainty of payment is the proper test for determining whether the obligator not only may but must accrue interest which by law continues to accumulate irrespective of financial condition. Subordination of an interest obligation even to an independent obligation does not preclude accrual.[2] Certainly, as here, subordination of one to the other of two equally indispensable elements, interest and indebtedness, does not preclude accrual; otherwise only that interest payable proportionately with the indebtedness would ever be deductible.

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[1] To affirm on a new theory, it was argued, when the question is not what the legal effect is of adequately developed facts but what the relevant facts actually are is to reach a result contrary in principle to this decisions of the Second Circuit (**McDonald v. Comm.**, 214 F.2d 341 (1954)) and of the Eighth Circuit (**Comm. v. Josephs**, 168 F.2d 233 (1948)). (R. 105.)

[2] **Guardian Investment Corporation v. Phinney**, 253 F.2d 326 (5th Cir. 1958).

Fahs v. Martin, 224 F.2d 387 (5th Cir. 1955); **Keeby's Inc. v. Paschal**, 188 F.2d 113 (5th Cir. 1951); **Zimmerman Steel v. Comm.**, 130 F.2d 101 (8th Cir. 1942).

The Court below did note a possible exception in the Second Circuit, where a parent-stockholder relationship exists. This exception, given as an alternative ground in **Prudence Securities Corp. v. Comm.**, 135 F.2d 340 (1943), was deemed so out of harmony with accepted principles as to prompt its description as nothing short of "alarming". 2 Mertens **Law of Federal Income Taxation**, Sec. 12.95.

[3] **Fahs v. Martin**, supra; **Keeby's, Inc. v. Paschal**, supra.

II. The rejection of the court below of taxpayer's analogy of its judgment obligations, when coupled with the provisions of the Allocation Agreement terminable on thirty days' notice, to an obligation payable no later than thirty days after notice and earlier if available cash were to exist, an obligation admittedly sufficient to support negotiability, in effect precludes the use of precedents in other fields in order to test an obligation for tax purposes.

III. In the District Court it was alleged that judgments had been rendered against taxpayer, that in the tax year, 1954, taxpayer "was *indebted*" to its two creditors, and that on that *indebtedness* interest thereafter ran. All of this was admitted except that it was denied that taxpayer was "entitled to accrue" that interest. It was also alleged, and admitted, that the Allocation Agreement provided "for priority and allocation of payments," thereby giving no hint of the shattering consequences said, much later and in another arena, to have erupted therefrom. It was stipulated that *"as of December 31, 1954, [taxpayer] was indebted in the aggregate to its two creditors in the amount*

"'A debt is that which is due from one person to another whether money, goods or services, that which one person is bound to pay to another, or perform for his benefit.' Webster's New International Dictionary. 'In order to create an indebtedness there must be an actual liability at the time, either to pay them, or at some future time.' Bouv. Law Dict., Vol. 2, page 1081. 'A debt must be solvendum in praesenti, or solvendum in futuro, must be certain and in all events payable, whenever it is uncertain whether anything will ever be demandable by virtue of the contract, it cannot be called a "debt." While the sum of money may be payable upon a contingency, yet in such case it becomes a debt only when the contingency has happened, the term 'debt' being opposed to 'liability,' when used in the sense of an inchoate or contingent debt.' 17 Corpus Juris 3377 (Citing cases.) The term 'indebtedness' as used in the Revenue Act implies an 'unconditional obligation to pay.' Any definition more flexible' would only encourage subterfuge and deception. Gilman v. Comm., 52 F.2d 47, 50; 80 A.L.R. 200 (8th Cir. 1931).

of $18,503,582.79" on the judgments. The stipulation set forth taxpayer's gross income in the tax year, also described the Allocation Agreement as providing for priority and allocation of payments, an agreement in which the creditors agreed to do nothing beyond merely applying any payments thereunder "on account" and then stated that except as they might be affected by said agreement, the judgments were outstanding liabilities on which by statute and decree interest accrued. Did this final statement, read as it must be in the light of the other stipulations of fact and admissions on the pleadings, constitute fair notice that issue was thus joined on whether or not taxpayer's judgment obligations were conditioned on available cash? If in the tax year the obligations had been conditioned on available cash and if such cash had not been available, then in that year taxpayer would obviously not yet have been in debt and would just as obviously not then have been obligated to pay $18,503,582.79. But we have a judicial admission and a joint stipulation that taxpayer was obligated to do precisely just that—an admission and stipulation squarely contrary to the finding of ultimate fact later elicited by the Government from the Court of Appeals.

IV. Once again the Government, in a suit on a claim for refund has indulged in its widespread and now nearly as widely recognized practice[9] of incorporating in its answer a simple denial of error, of relying on the concept as announced by this Court in *Lewis v. Reynolds*[10] and *Slone v. White*[11] that a claim for refund is an equitable ac-

[9] Small, **"Traps in Refund Suits,"** 29 Taxes 631 (1951).

[10] 284 U.S. 281, 76 L.Ed. 293, 52 S.Ct. 145 (1932).

[11] 289 U.S. 32, 81 L.Ed. 1207, 57 S.Ct. 431, (1937), modified 303 U.S. 577, 82 L.Ed. 691, 58 S.Ct. 760 (1937).

tion[7] in which the plaintiff must prove all facts essential to a recovery, and of assuming the position, which those cases are said to authorize, that a mere denial is ample dispensation to urge any and all defenses and theories of defense so long as they are calculated to defeat the right of recovery. There appears to be a division of opinion between the Sixth[8], Seventh[9], and Ninth[10] Circuits on one hand and the Eighth[11] Circuit on the other as to whether the Government may properly assume that position.

This case, however, represents an unacceptable extension of the practice even as condoned by some courts. Here the Government has withheld notice of its affirmative defense not only through the pleading stage, not only until all the evidence is in, but also until all proceedings before the trier of fact and the lower court have been concluded, and on appeal when it became the obviously prudent move to make, the Government finally unveiled the theory of its defense. Nor may the Government disclaim responsibility for the errors occasioned when the appellate court fully embraced the belated defense thus pressed upon it.

This case, it is believed, merits the allowance of a writ for the reasons apparent in the statement and more importantly in order to permit this Court to examine and, if appropriate, to arrest the expanding pleading and prac-

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[7] The fundamental validity of this concept has been seriously questioned. 10 Mertens, Law of Federal Income Taxation, § 55.21.

[8] Bolitzdin v. Brown, [illegible] (1938); problem of burden of proof; consult proper notice of defense analyzed [illegible].

[9] U.S. v. First Wisconsin Trust Co., [illegible] (1937).

[10] Powell v. U.S., [illegible] of 372 (1943); accord: Budd Co. v. U.S., [illegible] (1943), aff'd on other grounds, [illegible] (1945); Dupont v. U.S., [illegible] F. Supp. 122 (Ct. Cl. 1939).

[11] U.S. v. Pfister, [illegible] (8th Cir. 1953).

tice procedures of the Government in the administration of the Internal Revenue laws, the deft art of that expansion being no more perfectly illustrated than through the offering here. In a capsule taxpayer's complaint is this: It has brought its claim for refund through the offices of the Commissioner of Internal Revenue, through the United States District Court and Court of Appeals, and now into the Supreme Court in search of the appropriate forum in which it may *both* be advised of the theory relied on for rejection and be accorded the opportunity to be heard on the facts asserted to exist in support thereof. The fruitless result of that search to date calls for, we submit, the exercise of this Court's power of supervision.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 19700

BURLINGTON-ROCK ISLAND
RAILROAD COMPANY, Appellant,
versus
UNITED STATES OF AMERICA
Appellee.

Appeal from the United States District Court for the Southern District of Texas.

(August 27, 1963.)

Before HUTCHESON, WISDOM and GEWIN, Circuit Judges.

WISDOM, Circuit Judge: This appeal is from the district court's judgment denying plaintiff's claim for an income tax refund. (S.D. Tex. 1961), 200 F.Supp. 681.

The question for decision is whether the taxpayer, filing its returns on the calendar year, on an accrual basis, had a fixed and unconditional obligation in the taxable year 1954 to pay interest claimed as a deduction in that year. We affirm

the district court's holding that the obligation was not fixed and unconditional in 1954, and that therefore the taxpayer was not entitled to accrue and deduct the interest claimed in that year.

The facts are stipulated.

Burlington-Rock Island Railroad Company, the taxpayer, shortly after its incorporation in Texas in 1902, issued first mortgaged bonds in the amount of $8,760,000. Two companies, the Colorado and Southern Railway Company and the Chicago, Rock Island and Pacific Railroad Co., purchased and still hold all of the taxpayer's first mortgage bonds and all of the taxpayer's stock. In 1914, the taxpayer went into receivership as a result of a creditor's suit by Southern and Rock Island. The receivership was not terminated until 1931. During the course of the receivership Receiver Certificates, totalling $1,489,954.40, were issued in equal shares to the two creditor-stockholders. These creditors then forgave all accumulated interest on the certificates, then amounting to $11,641,789.89. Southern and Rock Island owned all of the Receiver Certificates, which in 1931 amounted to $1,489,954.

In 1946, at the suit of Southern and Rock Island, a federal district court in Texas rendered judgment in favor of the creditors and against the taxpayer for $19,659,844.66. Of this sum, $10,249,954, represented the unpaid principal of the bonds and certificates, and $9,409,890.26 the unpaid interest which had accrued thereon. By statute, the judgment bore interest at the rate of six percent per annum. Vernon's Texas Civil Statutes, Art. 5072.

Between the date of judgment and June 1, 1950, appellant paid $2,500 on the judgment, which was credited against the statutory interest then owing. In that year the taxpayer leased its lines to a subsidiary of Southern and to the Rock Island for an annual rental of $375,000, plus additional charges covering depreciation, overhead, and certain taxes other than federal income taxes. The taxpayer also entered into an Allocation Agreement with its two stockholder creditors. This agreement provided that the taxpayer would make payments on the judgments "from time to time, insofar as its cash situation will reasonably permit." Any sums so paid were to be credited first against the principal amount, $1,489,954.40, of the receiver certificates, then against the principal amount of the first mortgage bonds—$8,760,000, next against the unpaid interest on these two securities—$9,409,890.26; and finally against the statutory interest which was accruing on the judgment. The agreement was terminable on thirty days' notice by either party. Between 1950 and 1954 appellant paid $1,3,761.87 to its two creditors under this agreement.

In 1954, the tax year in question, Burlington realized a gross income of $471,888.63. It offset this entirely, however, by accruing an interest deduction of $1,119,716.38, representing the statutory interest of six percent on the unpaid balance of the judgment. This interest was not paid to the taxpayer's stockholder-creditors. The Commissioner disallowed this deduction and assessed a deficiency, which Burlington paid. Burlington's claim for refund was rejected and it then brought this suit. From an adverse ruling by the district court, taxpayer prosecutes this appeal.

I.

Neither party seriously disputes the basic principles of tax accounting applicable in this case. Section 163 of the Internal Revenue Code of 1954 authorizes a deduction for "interest paid or accrued within the taxable year on indebtedness." Section 461, which relates to the period for which a deduction shall be taken, provides that the "deduction . . . shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income." Burlington is an accrual basis taxpayer and is required to take its interest deductions annually if it has a fixed liability for the interest; if its obligation is contingent, a deduction is taken in the year of payment. See *Miller & Vidor Lumber Co. v. Commissioner*, 5th Cir. 1930, 39 F.2d 890, cert. denied 282 U.S. 864 (1930). The Third Circuit has summarized these principles as follows:

> In the case of a taxpayer on the accrual basis of accounting an item of expense is to be regarded as incurred, and hence deductible as accrued, only in the year when the taxpayer's liability to pay it becomes definite and absolute, whether or not it is presently paid or payable. On the other hand if the liability to pay the item of expense is wholly contingent upon the happening of a subsequent event the item cannot be regarded as incurred or deductible as accrued until the year in which by the occurrence of the event the contingent liability becomes an absolute one. Because interest is compensation for the use or forbearance of money it ordinarily accrues as an item of expense from day to day

> even though its payment may be deferred until a later date. But this is not true if the payment is not merely deferred but the obligation to pay at all is wholly contingent upon the happening of a later event as, for example, the subsequent earning of profits. In the latter case, the interest may not be regarded as an accrued expense until the year in which, by the earning of the profits, the contingency is satisfied and the obligation to pay becomes fixed and absolute. Pierce Estates, Inc. v. Commissioner, 3d Cir. 1952, 195 F.2d 475, 477-78.

Burlington's primary argument is that in attempting to apply these principles, the district judge disregarded the distinction between a legal condition to liability for interest and the economic improbability of its ever being paid. See *Guardian Investment Corporation v. Phinney*, 5 Cir. 1958, 253 F.2d 326. It urges that while, under the decisions of this court, a taxpayer cannot, if the contingency has not yet occurred, accrue interest which is not legally due until the occurrence of a contingency, it can accrue and deduct interest which it is legally obligated to pay, even if financially unable to pay it. Burlington contends that it was under a legal obligation to pay the statutory interest on the judgment and was, therefore, entitled to deduct it even though no payments were applied against this interest in 1954, or, under the present rate of payments under the Allocation Agreement, would be at any foreseeable time.

The distinction which Burlington seeks to draw was rejected in the Second Circuit when the interest was owed by a wholly owned subsidiary to its parent and

where no reasonable person could assume that the payment would ever be made. *Prudence Securities Corp. v. Commissioner*, 2d Cir. 1943, 135 F.2d 340. Burlington's argument, however, finds support in some decisions which carry accrual about as far as it can go. The Eighth Circuit has held that

> [W]here interest actually accrues on a debt of a taxpayer in a tax year the statute plainly says he may deduct it. That he has no intention or expectation of paying it, but must go into bankruptcy as this taxpayer was obliged to do, cannot of itself justify denial of the deduction in computing the taxpayer's net income. It is true that if a man's gains at the end of the year consist of bad debts he can have no net income to tax. But neither does he have net income if the interest on what he owes amounts to more than his gains. Zimmerman Steel Co. v. Commissioner, 8th Cir. 1942, 130 F.2d 1011.

Similarly, we stated in *Fabs v. Martin*, 5th Cir., 1955, 224 F.2d 387, 395, that "interest on an unconditional legal obligation is deductible for income tax purposes by an accrual basis taxpayer, notwithstanding the improbability of its being paid." It is true that here the district judge did comment that "the total plan reflects such an uncertainty of payment as to undermine the basic liability," citing *Guardian Investment v. Phinney*, 5th Cir. 1958, 253 F.2d 326, but he clearly stated in his opinion that:

> [T]he only question for decision thus resolves itself to whether there was a definite, fixed

> and existing obligation accruable during the tax year in point. . . . The intent of Section 163(a) of the Code, as delineated in the cases, is that interest on indebtedness is deductible in the year of accrual whether paid or not, if it represents a fixed, definite and existing obligation. [Citations omitted] As long as the obligation itself is demonstrably bona fide, present inability to pay or the unlikelihood of ultimate payment as an outgrowth of the economic vicissitudes of doing business, in and of itself, will not prevent the debtor from claiming a tax deduction for the year in which the debt becomes certain. [Citation omitted] But if the liability to pay the obligation is wholly contingent upon the happening of a subsequent event, the obligation cannot be regarded as incurred or deductible as accrued until the year in which by the occurrence of the event the contingent liability becomes an absolute one. Burlington-Rock Island R.R. v. United States, S.D.Tex. 1962, 200 F.Supp. 681.

The district judge's denial of the interest deduction was thus based primarily upon the contingent nature of the obligation to pay interest, for he found that it was "owed and payable only on the satisfaction of a series of conditions precedent."

II.

Burlington denies that it is not under a present legal duty to pay the statutory interest. It argues that the

Allocation Agreement merely subordinated the obligation to pay the six percent statutory interest to the obligation to pay the principal and previously accrued interest represented by the judgment. This arrangement was so tenuous that it could have been terminated by the creditors on thirty days' notice, or, Burlington suggests, the creditors could have sued on the judgment even while the agreement continued in force.

This argument, we believe, overlooks the true nature and purpose of the Allocation Agreement. It seems, basically, to be an executory accord. The rule governing such agreements has been summarized as follows:

> A composition with creditors in an agreement between a debtor and two or more of his creditors . . . whereby the creditors agree to accept in full satisfaction something different from or less than that which they originally claim. . . . It is most commonly a bilateral contract whereby the debtor promises to render the substituted performance and the creditors promise to receive it in full satisfaction. Such a composition agreement is an accord executory, resulting in a satisfaction and discharge of the original claims only when the new performance is rendered. After it is made, however, unless the contrary is clearly agreed on, it operates as a suspension of the orginal claims as long as the debtor has committed no material breach of it. It is an enforcable contract, so that either the debtor or the creditors can maintain action thereon in case of breach by the

other party. 6 Corbin, Contracts §1283, pp. 141-43 (1962 Rev.).

Here, Burlington's two stockholder-creditors agreed to accept in satisfaction of their judgment the taxpayer's performance of the conditional promise contained in the Allocation Agreements. Such an accord is an enforceable contract under Texas law. *Alexander v. Handley*, Tex. 1941, 146 S.W.2d 740; *Worth Petroleum Co. v. Callihan*, Tex.Civ.App. 1935, 82 S.W.2d 1060; *Rivers v. Campbell*, Tex.Civ. 1908, 111 S.W. 190; *Ward, Murray & Co. v. Young*, Tex.Civ.App. 1905, 89 S.W. 456; 1 Tex. Jur. 2d, Accord and Satisfaction, §§3, 41; *cf.*, Comment, The Requirement of Consideration of the Discharge of Contractual Obligations in Texas, 33 Texas L.Rev. 225 (1954). As such, regardless of the right in the creditors to terminate the agreement upon thirty days' notice, this was the contract under which the parties actually operated for four years and which conditioned the taxpayer's obligation to pay the interest here in question.

Under the terms of the Allocation Agreement, Burlington was required to make payments "from time to time, insofar as its cash situation will reasonably permit." Such a contract under Texas law would impose merely a conditional obligation on the debtor to pay, and he would be under no legal duty to make payments unless his financial situation permitted it. Thus a creditor could enforce such an obligation only by showing that the promissor has sufficient funds to make payment. See *Brickley v. Finley*, Tex.Civ.App. 1940, 143 S.W.2d 433; *Wright v. Farmer's Nat'l Bank*, Tex.Civ.App. 1903, 72 S.W. 103, and the cases cited therein. *Cf.*, *Worth Petroleum Co. v. Callihan*,

Tex.Civ.App. 1935, 82 S.W.2d 1060. Burlington's duty to pay the statutory interest was thus contingent upon its financial situation, and no legal obligation could arise under the agreement until the occurrence of that contingency.

This case is distinguishable from *Keebey's, Inc. v. Paschal*, 8th Cir. 1951, 188 F.2d 113. There payment of one creditor's notes had been postponed until all other obligations of the debtor had been met, but the legal duty for payment of the note was not dependent upon the debtor's ability to pay. In holding that the debtor should have accrued interest deductions on this note annually, instead of taking a deduction for the entire interest in the year in which it was paid, the Court stated:

> The parties to the written contract construed it to mean simply that the payment of the Keebey notes was to be postponed until appellant's other obligations were paid. The liability was fixed and certain and this liability we think that was not altered by the agreement between the creditors to postpone the time of payment. The right to deduct the sums as interest became absolute in the year when accrued even though actual payment was not made until 1942. 188 F.2d at 115.

The contract here in question does more than merely subordinate payment of statutory interest to payment of the principal and accrued interest represented by the judgment, for payment of any of the obligations is made contingent upon Burlington's ability to pay. This con-

tingency clause thus brings the Allocation Agreement much closer in substance to the contract involved in *Pierce Estates v. Commissioner*, 3rd Cir. 1952, 195 F.2d 475, than to the purely subordination agreement construed in *Keeley*. In *Pierce* the taxpayer was obligated to pay interest only from its net income "as ascertained and declared by its board of directors," that is, only when income permitted. The Court ruled that the taxpayer had properly deducted its interest in the year of payment rather than accruing it, for its legal duty to pay interest was wholly contingent upon the action of its directors. Similarly, in *Gonzales Bros. & Co. v. United States*, 5th Cir. 1961; 292 F.2d 79, where interest was due only as actual earning permitted, the deduction for interest was held to have been rightfully taken in the year when interest was actually paid. As the rule has been stated in Mertens, "where the obligation to pay interest is not absolute but is wholly contingent upon the earning of income out of which alone it is payable, the interest accrues when there are earnings available for its payment." 2 Mertens, Law of Federal Income Taxation §12.95 (1961 Rev.). See also *Guardian Investment Corp. v. Phinney*, 5th Cir. 1958, 253 F.2d 326; *Carlisle Tire & Rubber Co. v. Commissioner*, 3rd Cir. 1938, 168 F.2d 816; *Prudence Securities Corp. v. Commissioner*, 2d Cir., 1943, 135 F.2d 340. Cf., *United States v. Virgin*, 5th Cir. 1956, 230 F.2d 880. Under these decisions, taxpayer has no right to deduct interest which, under its Allocation Agreement, it is not now liable to pay.

III.

The taxpayer has made a final ingenious argument analogizing the Allocation interest, insofar as it refers

to the statutory interest, to a demand note payable thirty days after notice. Since, under Texas law, any payments on the judgment, absent the Allocation Agreement, would be allocable first to the statutory interest, these interest payments would become due and payable thirty days after termination of the agreement. A note, payable thirty days after demand is payable at a "determinable future time" for purposes of negotiability; therefore, argues the taxpayer, there is surely sufficient certainty of liability to justify accrual for income tax purposes.

Unfortunately for the efficacy of this line of reasoning, however, certainty of time of payment for purposes of negotiability is not necessarily the same thing as certainty of liability for income tax purposes. "As long as there is a question as to whether interest will be payable and what the rate will be, there can be no accrual. When interest is payable only on the happening of a contingency it cannot be accrued in a year when the contingency has not occurred." 2 Mertens, Law of Federal Income Taxation §12.95 (1961 Rev.), and see cases cited therein. Even with the construction of the contract here urged by the taxpayer, the obligation to pay interest is contingent upon a termination of the agreement by the creditors. If the creditors, who were also the debtor's sole stockholders, took no steps to exercise their rights of cancellation, the obligation to pay interest would continue to be governed by the Allocation Agreement, which made it, in effect, contingent upon earnings. Thus, Burlington's argument merely adds a second, alternative contingency to the one contained in the body of the contract. Since no termination did in fact take place during the tax year in question, no interest deduction was properly accruable.

The Judgment of the court below is AFFIRMED.

United States Court of Appeals

FOR THE FIFTH CIRCUIT

October Term, 1962

No. 19,700

D. C. Docket No. 13,371 Civil

BURLINGTON-ROCK ISLAND RAILROAD COMPANY, Appellant,

versus

UNITED STATES OF AMERICA, Appellee.

Appeal from the United States District Court for the Southern District of Texas

Before Hutcheson, Wisdom and Gewin, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Southern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

August 27, 1963

Issued as Mandate: Jan. 9, 1964

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 19,700

BURLINGTON-ROCK ISLAND RAILROAD COMPANY, Appellant

v.

UNITED STATES OF AMERICA, Appellee.

Appeal from the United States District Court for the Southern District of Texas

(December 27, 1963)

ON PETITION FOR REHEARING

Before HUTCHESON, WISDOM and GEWIN, Circuit Judges.

PER CURIAM:

It is ORDERED that the petition for rehearing filed in the above entitled and numbered caused is hereby DENIED.